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EXPOSURE DRAFT

PROPOSAL OF PROFESSIONAL ETHICS DIVISION

□ PROPOSED REVISION OF ET SECTION 92: DEFINITION of *Firm* □ PROPOSED
ADDITION TO ET SECTION 92: DEFINITION of *Network* □ PROPOSED ADDITION
TO ET SECTION 92: DEFINITION of *Network Firm* □ PROPOSED INTERPRETATION
101-17, *Networks and Network Firms*

August 13, 2007

Prepared by the AICPA Professional Ethics Executive Committee for comments
from persons interested in independence, behavioral, and technical standards
matters.

Comments should be received by November 13, 2007, and addressed to
Lisa A. Snyder, Director, Professional Ethics Division,
AICPA, 1211 Avenue of the Americas, 19th Floor,
New York, NY 10036 or via the Internet at lsnyder@aicpa.org.

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August 13, 2007

This exposure draft contains important proposals for review and comment by the AICPA's membership and other interested parties regarding pronouncements for possible adoption by the Professional Ethics Executive Committee (PEEC). The text and an explanation of the proposed pronouncements are included in this exposure draft.

After the exposure period is concluded and the PEEC has evaluated the comments, the PEEC may decide to publish one or more of the proposed pronouncements as exposed for comment or as modified based on comments received and re-deliberations by PEEC. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, except as may otherwise be stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses must be received at the AICPA by November 13, 2007. All written replies to this exposure draft will become part of the public record of the AICPA.

All comments received will be considered by the PEEC at an open meeting that will be announced in the *CPA Letter* and posted to the Professional Ethics Division's Web site.

Please send comments to Lisa A. Snyder, Director, AICPA Professional Ethics Division, AICPA, 1211 Avenue of the Americas, 19th Floor, New York, NY 10036 or via e-mail to lsnyder@aicpa.org. Comments submitted electronically are encouraged and would be appreciated.

Sincerely,

Bruce P. Webb
Chair
AICPA Professional Ethics
Executive Committee

Lisa A. Snyder
Director
AICPA Professional
Ethics Division

Professional Ethics Executive Committee (2006–2007)

Bruce P. Webb, *Chair*
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Proposed Interpretation 101-17, *Networks and Network Firms*

[Explanation]

The AICPA Professional Ethics Executive Committee (PEEC) is exposing for comment proposed Interpretation 101-17, *Networks and Network Firms*, under Rule 101, *Independence* [ET section 101.01], of the AICPA Code of Professional Conduct (the Code), and related new and revised definitions [ET section 92].

Background

CPA firms frequently form associations with other firms and entities and cooperate with them to enhance their capabilities to provide professional services. The PEEC formed a task force in the fall of 2006 to better understand how associations of firms operate with the goal of providing members with guidance on when the firms in these associations should be considered to be part of a *network* and therefore should be independent of each other's clients. In developing the proposed interpretation and related definitions, the PEEC sought input from various CPA firm associations and members of firms that participate in such associations.

Proposal

The proposed interpretation specifies that when firms and entities in an association cooperate with each other for the purpose of enhancing their capabilities to provide professional services and when they share certain characteristics, the association is considered to be a network, and the firms and other entities that belong to the network are considered to be network firms and must be independent of certain attest clients of the other network firms. Under the proposal, those shared characteristics are:

- The use of a common brand name in the firm name
- Common control among the firms
- Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that are designed and monitored by the association and that the firms are required to implement

Any firm or entity that a network firm (a) controls (either by itself or through its owners), (b) is controlled by, or (c) is under common control with would be considered a network firm. For example, if a CPA firm sets up a second firm that is controlled by some or all of its partners and if the second firm is a member of an association that is determined to be a network under this interpretation, both the CPA firm and the second firm would be considered to be part of that network and, thus, network firms.

Under this proposal, network firms should be independent of all other network firms' audit and review clients for which a general use audit or review report is issued (that is, use of the report is not restricted to specified users). For all other attest clients, a network firm should consider any threats that the firm knows or has reason to believe may be created by other network firms' interests in and relationships with the client and, if those threats are not at an acceptable level, apply safeguards to eliminate the threats or reduce them to an acceptable level.

If only a subset of firms within an association share one or more of the characteristics of a network firm (for example, a common brand name), only that subset of firms, rather than the entire association, would be considered a network for purposes of the proposed interpretation.

International Harmonization

In July 2006, the International Federation of Accountants (IFAC) adopted network firm guidance in its *Code of Ethics for Professional Accountants* that becomes effective for reports dated on or after December 31, 2008. The PEEC believes the proposed interpretation is consistent with the IFAC's guidance, which will make it easier for U.S. firms in an international association that is considered to be a network to be in compliance with the international guidance followed by non-U.S. firms in the network. Such consistent guidance will facilitate cross-border activities between members and non-U.S. practitioners and, in an increasingly global economy, is a desirable objective.

Effective Date

To provide members with sufficient time to implement an exit strategy (for firms and associations that choose not to operate as part of a network) or to educate personnel on new rules and implement monitoring systems (for firms and associations that choose to operate as networks), the PEEC is proposing a delayed effective date of the proposed interpretation and related definitions. Thus, the proposed interpretation and related definitions would be effective for engagements covering periods beginning on or after December 15, 2009.

Requests for Specific Comments

While the PEEC welcomes comments on all aspects of this proposal, it specifically requests feedback on the following issues:

1. The PEEC is proposing a delayed effective date of the proposed interpretation and related definitions. Do you agree that the proposed delayed effective date will provide firms with sufficient time to implement an exit strategy or to educate personnel on new rules and implement monitoring systems? If not, please advise what period of time would be sufficient and why you believe a different effective date would be more appropriate.
2. The PEEC believes network firms should be required to be *independent* of audit and review clients where the reports issued are not restricted to specified users. For all other attest clients (for example, compilations, SAS 70 reports, and examinations of prospective financial statements), the PEEC proposes that a network firm should consider any threats that the firm knows or has reason to believe may be created by other network firms' interests in and relationships with the client and, if those threats are not at an acceptable level, apply safeguards to eliminate the threats or reduce them to an acceptable level. Do you believe this proposed scope is appropriate? If not, please advise what scope would be more appropriate and why.

PROPOSED REVISED DEFINITION, *FIRM*, UNDER ET SECTION 92

[Text of Proposed Revised Definition Firm]

(Additions appear in boldface italic)

92.10 Firm. A firm is a form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting. Except for purposes of applying Rule 101: *Independence* [ET section 101.01], the firm includes the individual partners thereof. ***For purposes of applying Rule 101, firm includes a network firm when the engagement is either an audit or review engagement[∞] for which the audit or review report is not restricted for use by only the intended users specified in the report.***

Effective date

The additions to this definition would be effective for engagements covering periods beginning on or after December 15, 2009.

[∞] *Audit and review engagements are engagements under AICPA or International Auditing and Assurance Standards Board standards in which the member reports on:*

- *A complete set of general purpose financial statements;*
- *A complete set of financial statements prepared in accordance with a framework designed for a special purpose; or*
- *A single financial statement.*

PROPOSED NEW DEFINITION, *NETWORK*, UNDER ET SECTION 92

[Text of Proposed Definition Network]

92.28 Network. For purposes of Interpretation 101-17, *Networks and Network Firms*, a network is an association of entities that includes one or more firms (as defined in ET section 92.10) that (a) cooperate for the purpose of enhancing the firms' capabilities to provide professional services and (b) share one or more of the following characteristics:

- The use of a common brand name in the firm name
- Common control (as defined by generally accepted accounting principles in the United States of America) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that are designed and monitored by the association and that the firms are required to implement.

A network may comprise a subset of entities within an association if those entities cooperate and share one or more of the criteria set forth in the preceding list.

Effective date

This definition would be effective for engagements covering periods beginning on or after December 15, 2009.

PROPOSED NEW DEFINITION, *NETWORK FIRM*, UNDER ET SECTION 92

[Text of Proposed Definition Network Firm]

92.29 Network Firm. A network firm is a firm or other entity that belongs to a network, as defined in ET section 92.28. This would include any entity (including another firm) that the network firm, by itself or through one or more of its owners, controls (as defined by generally accepted accounting principles in the United States of America), is controlled by, or is under common control with.

Effective date

This definition would be effective for engagements covering periods beginning on or after December 15, 2009.

**PROPOSED INTERPRETATION 101-17, *NETWORKS AND NETWORK FIRMS*,
UNDER RULE 101**

[Text of Proposed Interpretation 101-17]

General

1. A network firm is required to be independent of audit and review clients¹ of the other network firms in the network if the audit or review report for the client is a general use report (that is, the use of the report is not restricted to specified users). For all other attest clients, consideration should be given to any threats the firm knows or has reason to believe may be created by network firm interests and relationships and, if those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. The independence requirements that apply to a firm that is a network firm also apply to any entity within the network that meets the definition of a network firm regardless of whether the entity itself meets the definition of a firm [ET section 92.10].
2. The judgment as to whether an association of firms is a network and whether a firm is a network firm should be applied consistently by all members of the association. Due consideration should be given to what a reasonable and informed third party would be likely to conclude after weighing all the specific facts and circumstances.
3. To enhance their capabilities to provide professional services, firms frequently form larger groups (associations) and cooperate with other firms and entities within the association. For example, an association may be formed only to facilitate the referral of work amongst the association members. That characteristic in itself would not be sufficient for the association to constitute a network. However, an association may be a network under this interpretation when one or more other characteristics are shared in addition to cooperating. These additional characteristics are discussed in the following section.

Characteristics of a Network

Sharing Common Brand Name

4. When the association is formed for the purpose of enhancing the firms' capabilities to provide professional services and when the entities within the association share the use of a common brand name in the name of the firm, those entities are considered to be a network. A common brand name includes common initials or a common name as part of the firm name.

¹ Audit and review engagements are engagements under AICPA or International Auditing and Assurance Standards Board standards in which the member reports on:

- A complete set of general purpose financial statements;
- A complete set of financial statements prepared in accordance with a framework designed for a special purpose;
or
- A single financial statement.

5. A firm that does not use a common brand name as part of its firm name but makes reference in its stationery or promotional materials to being a member of an association of firms should carefully consider how it describes that membership and take steps to avoid the perception that it belongs to a network. The firm may wish to avoid such a perception by clearly describing the nature of its membership in the association, for example, by stating on its stationery or promotional material that it is “an independent member firm of XYZ Association.”
6. If a firm sells a component of its practice, the sales agreement sometimes provides that, for a limited period of time, the component may continue to use the name of the firm or an element of the name even though it is no longer connected to the firm. In such circumstances, while the two entities may be practicing under a common name, they are not network firms. Such entities should disclose that they are not network firms when presenting themselves to outside parties.

Sharing Common Control

7. When the association is formed for the purpose of enhancing the firms’ capabilities to provide professional services and the when entities within the association are under common control (as defined by generally accepted accounting principles in the United States of America) with other firms in the association through ownership, management, or other means (for example, by contract), it is considered to be a network. However, an obligation to comply with certain association requirements as a condition of membership in the association does not indicate that the entities within the association are under common control; rather, it reflects the type of cooperation that is expected when an entity joins the association.

Sharing Profits or Costs

8. When the association is formed for the purpose of enhancing the firms’ capabilities to provide professional services and when the firms share profits or costs, the association is considered to be a network. However, the sharing of immaterial costs or costs related to operating the association would not in itself create a network. In addition, the sharing of costs related to the development of audit methodologies, manuals, and training courses would not in itself create a network. Further, an arrangement between a firm and an otherwise unrelated entity to jointly provide a service or develop a product would not in itself create a network.

Sharing Common Business Strategy

9. When the association is formed for the purpose of enhancing the firms’ capabilities to provide professional services and when the entities within the association share a common business strategy, it is considered to be a network. Sharing a common business strategy involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association’s strategy and are held accountable for performance pursuant to that strategy. An entity’s ability to compete against other firms within the association and pursue an alternative strategy is limited because it must act in accordance with the common business strategy and in the best interest of the association. An entity is not considered to be a network firm merely because it cooperates with another entity solely to market professional

services or respond jointly to a request for a proposal for the provision of a professional service.

Sharing Significant Professional Resources

10. When the association is formed for the purpose of enhancing the firms' capabilities to provide professional services and when the entities within the association share a significant part of professional resources, it is considered to be a network.

11. Professional resources include:

- Common systems that enable firms to exchange information such as client data, billing, and time records;
- Partners and staff;
- Technical departments to consult on technical or industry-specific issues, transactions, or events for assurance engagements;
- Audit methodology or audit manuals; and
- Training courses and facilities.

The determination of whether the professional resources shared are significant should be made based on both qualitative and quantitative factors.

12. When the entities within the association do not share significant personnel or significant client information (for example, client data, billing, and time records) and have the ability to make their own independent decisions regarding technical matters, audit methodology, training, and the like, the entities would not be considered to be sharing a significant part of professional resources.

13. When the shared resources are limited to a common audit methodology or audit manuals or common training courses and facilities, with no significant sharing of personnel or significant client or market information, the shared resources would not be considered significant. However, when the shared resources involve the exchange of client information or personnel, such as where staff are drawn from a shared pool, or a common technical department is created within the association to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

Sharing Common Quality Control Policies and Procedures

14. When the association is formed for the purpose of enhancing the firms' capabilities to provide professional services and when the entities within the association share common quality control policies and procedures designed and monitored² by the association that the entities are required to follow (which allows entities to rely on the work of others in the association), it is considered to be a network. For example, in the case of an audit, a firm

² Monitoring is the process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

would be able to rely on the audit performed by another firm within the association without having to satisfy itself as to the independence, professional reputation, and quality of audit work performed by the other firm.³

Effective date

This interpretation would be effective for engagements covering periods beginning on or after December 15, 2009.

³ As described in AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1).